Corporate Governance: Expectations for Effective Oversight

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Introduction

Corporate Governance:

- Board and management responsibilities
- Audit and internal controls
- Self-dealing and conflicts of interest
- Best practices
- Resources for directors and management

Definition of Corporate Governance

Corporate governance is the set of processes, customs, policies, and laws affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed.

Stakeholders

Who are Directors Responsible To?

- Shareholders
- Depositors
- Customers
- Community
- Regulators/Chartering Authority/Government
- Employees & Management
- Other Board Members

Basic Duties

- Duty of Loyalty – Administer the affairs of the bank with personal honesty and integrity. Directors are prohibited from advancing their own personal or business interests, or those of others, at the expense of the bank.
- Duty of Care – Act as a prudent and diligent business person in conducting the affairs of the bank.

Maintain an Appropriate Board Structure

- Establish Board committees
- Some committees are required by regulation/supervisory policy
  - Audit Committee for any banks with assets in excess of $500 million
  - Trust Audit Committee for a bank with trust powers
  - Audit, Compensation, and Corporate Governance Committees for banks whose securities are registered with the SEC
- Consider other committees to address identified risks such as Compliance, Lending and Investments.

Establish an Appropriate Corporate Culture

- Set the appropriate tone
- Avoid conflicts of interest and self-serving practices
- Establish a code of ethics
  - Conflicts of interest
  - Self-dealing
  - Protection and proper use of bank assets
  - Financial recordkeeping integrity
  - Compliance with laws, rules, and regulations
  - How to report illegal or unethical behavior (i.e. a whistleblower policy)

Hire and Retain Competent Management

- Select, define the duties of, monitor, and evaluate qualified/competent management
- Dispense with the services of officers who prove unable to meet reasonable standards of executive ability
- Plan for management succession
- Personnel administration and training

Oversee Bank Operations

- Attend Board and committee meetings
- Request and review meeting materials
- Ask questions and seek explanation of problems
- Review audits and supervisory communications
- Exercise independent judgment
- Maintain well-documented minutes
- Avoid or manage dominant policymakers

Establish Strategic Plans & Operating Policies

- Long-term strategic plan
- Short-term business plan
- Policies/Procedures

Risk Management Function & Internal Controls

- The Board should provide for a comprehensive and independent risk management function and an effective system of internal controls.
- Internal control system should:
  - Prevent or detect significant inaccurate, incomplete, or unauthorized transactions
  - Identify deficiencies in safeguarding assets
  - Detect unreliable financial reporting
  - Identify deviations from laws, regulations, and bank policies

Risk Management Program

- Establish an effective risk management program
- Ensure the program is commensurate with the bank's size and complexity
- Implement a compliance management system

Audit Program

- A strong audit program is an important component of an independent risk management function.
- The audit process provides directors and senior management with vital information about weaknesses in the system of internal controls so that management can take prompt, remedial action.
- The Board’s responsibility to establish and oversee the audit program cannot be delegated.

Audit Program (Continued)

- The audit function should address risks and demands of an institution's current and planned activities.
- Audit programs should be flexible and responsive to changes in the bank's risk profile.
- Strategic vision discussions should plan for audit coverage.

Internal Audit Program

- The internal audit program should cover all major business activities and risk areas.
- Control risk assessment analyzes: risks inherent in business lines, mitigating controls, and residual risk.
- The internal audit plan is established based on the control risk assessment results.
- The Board should review and approve the control risk assessment and the internal audit plan.

Insufficient Internal Audit Plans

- Several instances in the NY Region where the internal audit plan was insufficient:
  - Major business line related to online gambling had not been reviewed.
  - Insider transactions/expenses were not reviewed or the review was insufficient.
  - Third-party activities had not been adequately reviewed.

Audit Communications

- Whistleblower policies are an important part of a comprehensive risk management function.
- Such policies are recommended by the Interagency Policy Statement on Internal Audit Function and FIL 80-2005 entitled Guidance on Implementing a Fraud Hotline.
- Audit Committee should meet in executive session with auditors.

Avoiding Self-Serving Practices

- Avoid self-serving practices and conflicts of interest, including excessive compensation.
- Never use influence for personal advantage or gain.
- Never misuse customers’ confidential information.
- Place performance of duties above personal objectives.
- Avoid appearances of conflicts of interest.

Personal Interests

- Put the operations, interests and reputation of the bank above any personal interests.
- Exercise the utmost fairness.
- Act in good faith.
- Guard the interests of the bank.
- Fully disclose personal interests.
- Recuse yourself from discussing and voting on any matter in which you have a personal interest.

Why Avoid Self-Serving Practices?

- Self-serving practices can:
  - Result in personal liability for a director or officer of a bank.
  - Create an atmosphere where other employees think they can engage in similar practices.
  - Create reputational, financial, and legal risk for the institution.

Actions that May Create Personal Liability

- Actions that may create personal liability are as follow:
  - Negligence resulting in a loss to the institution
  - Breach of Trust
  - Fraud
  - Misappropriation or conversion of assets

Liability for Negligent Acts

- Board members may be liable for negligent acts if they fail to exercise a degree of care with regard to statutory law, and cause loss or injury to institution. There are many examples of negligent acts for which a director could be held personally liable.

Examples of Negligent Acts

- Attitude of indifference to the affairs of the bank
  - Failure to hold meetings
  - Failure to obtain a financial condition statement
  - Failure to arrange audits
  - Failure to address regulatory and audit recommendations
  - Failure to adopt practices and follow procedures
  - Failure to conduct due diligence for third-party activities

Examples of Negligent Acts (Continued)

- Relinquishing control to officers and employees
- Assenting to loans in excess of applicable statutory limits
- Breaching internal policies
- Misrepresenting financial statements

Insider Dealings/Conflicts of Interest

- Regulation O/Borrowing Relationships
- Other Business Relationships/Insider Transactions
- Code of Ethics/Conduct

Regulation O

- Regulation O governs any extension of credit to an executive officer, director or principal shareholder of the bank, as well as related interests of such individuals (insiders) .
- Credits extended to any insider must be made on substantially the same terms and conditions as with other persons not employed by the bank – this includes interest rates and collateral.
- Underwriting procedures for Regulation O loans should be as stringent as those prevailing for comparable transactions at the bank.
- Regulations O loans must not have more than normal repayment risk or other unfavorable features.

Loans to Insiders

- Loans to insiders may total 15% of unimpaired capital and surplus.
- Insiders can borrow an additional 10% if fully secured by marketable and available collateral equal to at least the amount of the loan.
- Aggregate debt to an insider exceeding the higher of $25 thousand or 5% of unimpaired capital and surplus must receive prior majority Board approval.
  - In all cases, aggregate debt exceeding $500 thousand must be approved in advance.
  - Interested parties should abstain from voting on personal loans.

Loans to Executive Officers

- Loans to executive officers have the same restrictions as for directors and principal shareholders for education, home purchase or home improvement loans.
- For all other loans, the officer may borrow the greater of $25 thousand or 2.5% of unimpaired capital plus surplus, up to $100 thousand.
- The $100 thousand limit may not be increased by board approval.

Other Regulation O Considerations

- All insider loans, when aggregated, may not total more than 100% of unimpaired capital and unimpaired surplus.
- Banks with deposits less than $100 million may pass an annual board resolution to increase the aggregate limit to 200%, provided that the bank has a satisfactory composite rating and meets or exceeds all capital requirements.
- Banks must identify all insiders and maintain records of all extensions of credit to such individuals, including amounts and terms of each loan.
- Regulation O also restricts overdrafts.
- Loans to affiliates are covered under Sections 23A and 23B of the Federal Reserve Act.

Other Business Relationships

- Can include deposits, legal transactions, appraisals, real estate, insurance, and other business relationships.
- All business arrangements should be handled in a manner that is above and beyond reproach.
- All business relationships should be disclosed.
- Sarbanes Oxley (SOX) Section 404 seeks to promote the avoidance of conflicts by requiring disclosures for public companies.
- Even appearances of conflicts of interest should be avoided.

Code of Ethics/Conduct

- A Code of Ethics defines acceptable business practices and behaviors.
- Section 404 of SOX requires companies to disclose whether they have adopted a code of ethics.
- A strong code of ethics and expectation for conduct help ensure that conflicts are avoided and that the interests of the bank take precedence. Nominee loans should be prohibited.
- Nepotism should be addressed in all ethics policies.

FDIC Statement of Policy (SOP)- Corporate Codes of Conduct

- FDIC SOP Corporate Codes of Conduct – Guidance on Implementing an Effective Ethics Plan (2005)
  - Provide employees, officers and directors with specific guidelines for acceptable and unacceptable business practices
  - Cover entire organization, including subsidiaries. Adopt provisions that explain the Federal Bank Bribery Act
  - Provide for periodic training
  - Ensure all employees give written acknowledgement of the policy
  - Monitor compliance and take action against violators
  - Include a reporting mechanism

Poor Corporate Governance Impacts Condition of the Bank– Example 1

- Management at a de novo bank decides to engage in originating indirect auto loans. The Board does not include the activity in the strategic plan or forecasts.
- Board does not identify risks, adopt sufficient internal controls, or provide for monitoring.
- Results include inadequate loan policies, internal control weaknesses, failure to provide internal audit coverage or independent loan review, and accounting system weaknesses.
- Chairman receives excess compensation packages based on bonuses for indirect auto loan activity.
- Within two years of opening, Composite, Management, Asset Quality and Earnings were downgraded to 4 from ratings of 1,2, and 3. One year later, Capital and Liquidity are downgraded. Later, ratings were downgraded to 5 and bank ultimately failed.

Poor Corporate Governance Impacts Condition of the Bank– Example 2

- Former President and CEO took advantage of weak oversight and controls and personally financially benefited.
- Former CEO was a dominant individual.
- Former CEO set up “straw” loans, including a $600 thousand loan to purchase a yacht.
- Former CEO set up a nominee passbook loan under the name of an unsuspecting customer, and used the proceeds himself.
- Asset Quality, Management, and Capital ratings were downgraded to 4. The Composite rating was downgraded to 4. A Consent Order was issued.
- The bank lost almost $2.3 million based on the CEO’s actions.
- Former CEO stipulated to an 8(e) removal enforcement action.

Best Practices

- Right size your Board
- Establish an effective committee structure
- Institute a formal compensation program
- Develop executive officer succession plans
- Evaluate Board meeting effectiveness
- Perform director evaluations
- Provide for ongoing director education and training
- Provide for director accountability

Regulatory Guidance References

- FDIC Rules and Regulations
  - Part 337.3 - Limits on Extensions of Credit to Executive Officers, Directors, and Principal Shareholders (Federal Reserve Board Regulation O)
  - Part 364 – Standards for Safety & Soundness
  - Part 359 – Golden Parachutes & Indemnification Payments
  - Part 363 – Annual Independent Audits and Reporting Requirements

Regulatory Guidance References (Continued)

- FDIC Statements of Policy
  - FIL 105-2005 – Corporate Codes of Conducts – Guidance on Implementing an Effective Ethics Program
  - FIL 21-2003 – Interagency Policy Statement on the Internal Audit Function and Its Outsourcing
  - FIL 96-99 – Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations
  - FIL 80-2005 – Fraud Hotline- Guidance on Implementing a Fraud Hotline

Regulatory Guidance References (Continued)

- Other FDIC Resources
  - FDIC.gov – Director’s Resource Center
  - FDIC Pocket Guide for Directors

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Questions

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